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THE WHITE HOUSE
WASHINGTON

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CABINET AFFAIRS STAFFING MEMORANDUM

DATE: 3/30/82 NUMBER: 050197CA DUE BY: ----

SUBJECT: CABINET COUNCIL ON ECONOMIC AFFAIRS -- April 2 Meeting

	ACTION	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	✓	☐
State	✓	☐
Treasury	✓	☐
Defense	☐	✓
Attorney General	☐	✓
Interior	☐	✓
Agriculture	✓	☐
Commerce	✓	☐
Labor	✓	☐
HHS	☐	✓
HUD	☐	✓
Transportation	✓	☐
Energy	☐	✓
Education	☐	✓
Counsellor	✓	☐
OMB	✓	☐
CIA	☐	✓
UN	☐	✓
USTR	✓	☐
CEA	✓	☐
CEQ	☐	☐
OSTP	☐	☐
____	☐	☐
____	☐	☐

	ACTION	FYI
Baker	✓	☐
Deaver	☐	☐
~~Anderson~~ Harper	✓	☐
Clark	✓	☐
Darman *(For WH Staffing)*	✓	☐
Jenkins	☐	✓
Gray	☐	✓
Beal	☐	✓
Mike Wheeler	✓	☐
Larry Kudlow	✓	☐
____	☐	☐
____	☐	☐
____	☐	☐
____	☐	☐
CCNRE/Boggs	☐	☐
CCHR/Carleson	☐	☐
CCCT/Kass	☐	☐
CCFA/McClaughry	☐	☐
CCEA/Porter	✓	☐

REMARKS:

The Cabinet Council on Economic Affairs will meet on Friday, April 2, at 8:45 AM in the Roosevelt Room. The agenda and papers for that meeting are attached.

RETURN TO: Craig L. Fuller
Assistant to the President
for Cabinet Affairs
456-2823

THE WHITE HOUSE

WASHINGTON

March 30, 1982

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER RBP

SUBJECT: Agenda and Papers for the April 2 Meeting

The agenda and papers for the Friday, April 2 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 8:45 a.m. in the Roosevelt Room.

The first agenda item is an investment initiative that the United States might advance at the Versailles Economic Summit in June. A paper, prepared by the Department of the Treasury, on this subject is attached. The possible initiative concerns the need for international rules governing investments analogous to the GATT rules for international trade.

The second agenda item is an initiative on international economic cooperation in response to pressure on the United States to intervene in international exchange and interest rate markets. A paper, prepared by the Department of the Treasury, on this subject is also attached.

Attachments

THE WHITE HOUSE

WASHINGTON

CABINET COUNCIL ON ECONOMIC AFFAIRS

April 2, 1982

8:45 a.m.

Roosevelt Room

AGENDA

1. Versailles Summit: Investment Initiative (CM#227)

2. Versailles Summit: International Economic Cooperation (CM#234)

THE UNDER SECRETARY OF THE TREASURY
FOR MONETARY AFFAIRS
WASHINGTON, D.C. 20220

CM 227

MAR 24 1982

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: Under Secretary Sprinkel BWS

SUBJECT: Versailles Summit Issues

In preparation for the Versailles Summit, June 4-6, the United States is working on two major initiatives: Rules for Multinational Investment and International Economic Cooperation.

The basic thrust in the paper on Rules for Investment is that we have GATT rules in the international arena for trade, but we have no such international rules for investments. There has developed a critical need in recent years for such rules as discrimatory practices have become more widespread. Rules are particularly important now as we face growing protectionist pressures.

The initiative on international economic cooperation is in response to pressure on the United States to "cooperate" by intervening in exchange and interest rate markets. These market rates are merely the symptoms of the lack of coordination of basic policies. If we are truly to achieve successful economic coordination among our nations it must be by attacking the root causes of our problems, not the symptoms. If the economies of different nations are going in divergent directions it cannot be expected that there will be stable exchange rates or low and stable interest rates. This initiative will place the U.S. Government in an appropriate offensive stance in contrast to our present defensive posture.

We hope to get the approval of the CCEA on both of these initiatives. We then plan to circulate the Summit papers among our Summit allies for consideration prior to the Versailles Summit. If approved, it also is our intent to launch an extensive discussion of each idea in the appropriate international fora.

3/23/82

VERSAILLES SUMMIT: INVESTMENT INITIATIVE

Foreign investment is beneficial to all our economies. Like domestic investment it introduces new technology, creates employment, and improves productivity.

International investment decisions that are market-oriented will result in the most efficient and profitable allocation of capital. Hence capital which is likely to be a relatively scarce and more expensive resource during the 1980's will be most productively employed, to all countries benefit, where it is not constrained. Moreover, cooperation among developed and developing nations can create an international environment in which investment can make a greater contribution to the development process.

The present global economic system, which covers the trade and monetary areas was developed during the immediate post-WW II period, and is based on the general principle of free or open markets. Governments generally committed themselves to the expansion and balanced growth of trade through non-discriminatory practices, through the reduction of barriers to trade and through the avoidance of shortsighted national income, monetary and balance of payment and employment policies which harm other countries and the global economic system.

We have nurtured and developed this international framework in the trade and monetary areas in subsequent years. Although the system is threatened periodically, and although much work remains, we have made considerable progress. We are also committed to moving forward, to continuing to progress.

Despite the increased importance of international investment to countries and to the global economic system, no comparable framework exists for international investment. Government intervention in international investment decisions is increasing. Both developing and developed countries are introducing measures to control or to tip the benefits of foreign investment in their favor.

These interventionist, often nationalistic, policies take many forms, including:

-- incentives to attract investment or to direct it to specific sectors or geographic areas;

-- conditions relating to equity participation, technology transfer, and financing; and

-- performance requirements, relating to local content, exports and/or imports and employment.

The effects of these practices though difficult to measure are demonstrably negative for both the home and host countries and the global economic system as well.

Generally trade and investment flows are distorted and resources are not allocated efficiently. For home countries, export opportunities and associated employment are lost due to institutional factors not as a result of comparative disadvantage. Host countries often foster the development or expansion of inefficient industries and expend substantial funds on incentives which often are of no consequence to the investment decision or are at best marginal. The budgetary problems of some poorer countries who believe they must compete or be passed by are thereby exacerbated. Unrestrained use of these types of measures is causing serious divisive strains among countries, fueling protectionist pressures and gradually eroding the progress we have so painstakingly achieved. Continued use of these measures could also jeopardize the important role of investment in promoting development. Since the mid-1970's, there have been important changes in international trends and forms of investment. The pace of international direct investment flows has slowed, particularly to many developing countries. This is a disturbing trend. The forms of investment, traditional foreign subsidiary or branch plant operations, are also being supplanted by joint ventures, coproduction, licensing and other arrangements. The international community can play a helpful and at times critical

role in this regard in facilitating private investment flows to developing countries; but developing countries should recognize that they also have a responsibility to create a favorable internal climate for foreign investment.

Much useful work relating to international investment has been done in multilateral fora and more is planned. The OECD countries in the OECD Investment Declaration and related decisions have reached consensus encompassing: the extension of national treatment to foreign investors; agreement to give "due weight" to the effects of incentives and disincentives to direct investment on OECD countries; and the establishment of (voluntary) guidelines for multinational enterprises (MNE's). However, these instruments are not binding; they contain no enforcement procedures or sanctions.

The OECD's Code of Liberalization of Capital Movements contains provisions relevant to international investment and represents a commitment by OECD countries adhering to the Code to progressively abolish restrictions on capital movements.

Agreement has been reached also in the United Nations International Labor Organization Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy and the UN Code on Restrictive Business

Practices. Work is also proceeding on a possible Code of Conduct Relating to Transnational Corporations and an International Code of Conduct for the Transfer of Technology.

In the IMF/IBRD, the Development Committee's Task Force on Private Foreign Investment has reviewed the role of investment incentives and performance requirements in international direct investment flows and recommended additional detailed study on the impact of these measures on investment flows. The International Finance Corporation began this study in February 1982. The study will attempt to quantify the impact of investment and performance requirements for four industries in ten developed and developing countries. Information derived from this study will enhance our understanding of these issues and may suggest future directions that the IMF/IBRD should take on these issues.

While these efforts have been extremely beneficial and should continue there is a strong need to escalate multilateral efforts in this area.

Summit countries recognize that international investment is an activity of growing importance to the international economic system and to individual countries. These countries also agree that the proliferation of national measures to control investment has serious adverse consequences for the international economic system.

The Summit countries therefore:

-- reaffirm their commitment to strive for a free and open system for trade and investment;

-- reaffirm their commitment to existing principles that have been developed in the OECD and elsewhere;

-- recommend that work on international investment issues, in various fora, should be intensified and escalated in order to clarify issues, determine their impact and consider what actions might be adopted to eliminate or discipline these measures;

-- recognize that the newly industrialized countries (NIC's) need to be brought into any global understanding on investment. These countries are important players in the world trading system, are beginning to export capital, and their national policies (for example on incentives) may be very harmful to other developing countries. Also any standards relating to investment should take into account the different stages of economic development of these countries; and

-- agree that a major objective of the GATT Ministerial should be to underscore the existence of these problems and to initiate a comprehensive work program

on trade related investment measures (i.e., both incentives and disincentives, such as performance requirements).

It may be premature to speculate on the precise institutional arrangements which should be developed to address global investment problems of the 1980's and beyond. The Summit countries, however, have an immense stake in the health of the global economy, and investment issues are an important part of the question. The Summit countries should ensure that relevant international organizations address investment issues in a serious way, in the expectation that their efforts might eventually lead to appropriate international understandings and commitments on investment.

3-23-82

U.S. Theme Paper: Multilateral Initiatives on International Investment

There is agreement in the U.S. Government that we need to develop some multilateral discipline (rules of the road) relating to international investment. Government intervention in international investment decisions is growing and investment problems are increasing. Existing mechanisms are inadequate to deal with these problems.

There is also agreement that the upcoming Summit and OECD and GATT Ministerial meetings offer the U.S. Government opportunities to:

-- present our proposals relating to international investment to high-level foreign government officials;

-- exchange ideas with these officials regarding those proposals; and

-- seek commitments from other governments to begin the process of developing some multilateral discipline in this area.

A general consensus is also developing in the U.S. Government on:

-- the scope of our initiative, i.e. what issues and/or countries it should embrace; and

-- the venue (s) for our initiative.

This paper outlines current agency thinking regarding the scope and venue of multilateral initiatives and includes a short discussion of U.S. strategy.

Scope

Investment issues may be divided into two categories--issues relating to entry (new investment) and issues relating to treatment (old or existing investment (see chart 1). Scrutiny of these issues has been confined largely to three institutions: the OECD, the UN and the World Bank. Aside from the little used ICSID and ICJ, the few rules on investment that have been developed by international institutions fall primarily in the area of treatment of existing investment--the OECD Declaration and the World Bank lending policies which take account of expropriation. The CMIT is still debating rights of establishment, and the GATT, at our initiative is testing the applicability of GATT articles to performance requirements.

Selection of issues for a U.S. initiative on investment should be based initially on:

-- the importance of these issues to the international economic system (which practices do or will do the most damage);

-- interest expressed by business, labor, and the Congress; and

-- the status of work on issues.

Agreement on a final list of issues will depend on other factors, particularly the willingness of other countries to consider these issues.

Based on the above listed parameters, the following issues are recommended for inclusion in any investment initiative:

-- issues relating to entry (rights of establishment, performance requirements, other requirements and incentives); and

-- issues relating to treatment (national treatment, nationalization, compensation, and dispute settlement).

Rights of establishment--are an integral element of services trade. Failure to clarify rights of establishment will kill or cripple any negotiation of services.

Performance requirements--lead to potentially significant distortions of trade and investment flows. They may nullify or impair benefits under the GATT. U.S. business interest in performance requirements is mixed. For some firms performance requirements are a priority issue. Others consider other requirements as equal to or of greater priority than performance requirements. Their desires to guard proprietary technology and retain control are critical. Finally, another group of firms, primarily large multinationals, is concerned more with investor protection i.e. national treatment and compensation.

Other requirements--may jeopardize the operation of foreign investors either in a specific host country or generally. U.S. high technology firms are particularly concerned with equity and technology transfer requirements.

Incentives--incentives often translate into subsidization and lead to destructive competition between countries trying to attract investment. This is particularly true for poorer LDCs.

National treatment--host country governments may change their economic programs in a manner that discriminates against and may severely damage foreign investment already in place. An example is Canada's National Energy Program (NEP).

Nationalization and compensation and dispute settlement--U.S. firms are becoming more concerned with investor protection. Although rules relating to expropriation and dispute settlement exist, they are seldom used and issues sometimes linger interminably.

Location of U.S. Initiatives and Objectives

The United States will encounter opposition to almost any initiative we propose in the investment area. Objections to any initiative would, however, be much more strident if we attempted to create a new institution either independent of or as an adjunct to an existing institution to deal primarily with international investment issues. The idea of handling these issues in a totally new institution is, therefore, not realistic.

It is also unrealistic to attempt to handle all of these issues in any one institution. During the initial stages of our initiative we are proposing that we continue to gather information and to study the issues. There is, therefore, no reason to shift review of these issues out of the institutions currently considering them. In fact, trying to change now would only disrupt and delay progress. The U.S. should consider pulling these issues into one or more relevant institutions only when we reach a negotiating or decision-making stage.

What this approach recommends, therefore, is that in the near term we continue to pursue international investment issues in several different fora, with coverage of each institution being determined by past and planned work programs and the existence of relevant mechanisms and rules we might build on. With this in mind, we suggest the following allocation of issues by institutions and the following objectives regarding each issue.

Right of Establishment. Work in this area should be retained by the OECD Capital Movements and Invisible Transactions Committee (CMIT). The United States should work vigorously to develop an agreement with limited exceptions and, ideally, binding commitments. Since it may be extremely difficult to reach a consensus in the OECD on rights of establishment, the U.S. might wish to consider entering into a multilateral agreement with those OECD countries willing to do so. The results of that exercise may be used and perhaps refined by services work in the Trade Committee and negotiations in the GATT.

Performance Requirements. Work being conducted by the OECD CIME, CMIT, and the Trade Committee should continue and if possible be accelerated. The United States should support the International Finance Corporation (IFC) study of the implications of investment incentives and performance requirements. We should continue also to press the Canadians in the GATT on Articles XXII and XXIII.

The U.S. should propose at the OECD Ministerial that work underway in this area by various OECD committees should

be accelerated, that the committees should prepare a report to the Secretary General on their progress and plans for future work, and that a detailed report of the committees' results be prepared for the Secretary General.

The U.S. should also propose at the GATT Ministerial that the GATT embark on a program relating to trade related performance requirements, including:

-- the identification and development of an inventory of investment practices that distort or restrict trade flows of all countries, and assess the impact and relative importance of these practices on international trade; and

-- an examination of which GATT rules apply and an analysis of how these rules might be strengthened to deal more explicitly with direct trade-related investment practices.

There is a question, however, as to whether our proposal for a GATT work program would jeopardize the Articles XXII and XXIII consultations with the Canadians on the FIRA. The Canadian Government could argue that the applicability of GATT rules to performance requirements is a matter of discussion and therefore the GATT Article XXIII panel should not make a determination until the proposed work program is completed. However, according to USTR the Canadian argument won't be upheld.

Other Requirements. The United States should press for the OECD/CIME to add work on these issues (e.g., technology transfer, equity participation) to work currently planned on performance requirements; and we should support the IFC

study in its investigation of these requirements. The U.S should at the same time solicit information from the U.S. private sector regarding these requirements and the problems they create.

Some private sector officials argue that establishment of a presence in a foreign country is essential to trade with that However, this type of investment, is often precluded by onerous equity and technology transfer requirements.

As work progresses in the GATT, the U.S. may also wish to request that the GATT analysis of performance requirements be extended to include these other requirements. Including them in the first stages of a GATT work program may overload the exercise. They could possibly be included, however, in the inventory.

While these types of measures are not confined to developing countries, they are often employed by developing countries for developmental and/or balance of payments reasons. It might be possible to request that the IFC in its loan activities carefully scrutinize projects to analyze the implications of these types of measures on project performance.

Incentives. Work on incentives in the OECD is well advanced and should be pressed to a conclusion. The U.S. should support the IFC study on incentives and disincentives, emphasizing in particular the need to make at least preliminary judgments regarding the effectiveness and desirability of incentives in attracting foreign investment. Consideration should also be given to including incentives in the GATT

analysis of trade-related investment issues. Discussion of this issue may appeal to LDCs who are finding it increasingly difficult, because of budget constraints, to compete with wealthier neighbors to attract foreign investment

National Treatment. The U.S. Government should attempt to accelerate the OECD CIME review of the national treatment instruments. The current schedule calls for the review and work relating to the extension of national treatment to be completed by 1984.

Depending upon the outcome of the Article XXIII consultations with Canada and/or any GATT work program on performance requirements, the U.S. may also wish to request that the GATT take up the question of national treatment as it relates to trade.

Nationalization, Compensation, and Dispute Settlement. The U.S. could in a low key manner support current World Bank efforts to increase membership in the ICSID. We could do this in conjunction with our overall Cancun initiative to promote private investor participation in the development process and to liberalize the investment climate in developing countries. This effort also might be undertaken in conjunction with multilateral insurance schemes which are now being developed. The U.S. Goverment might also request that the World Bank adopt a more rigorous test of country credit worthiness in considering projects, giving more weight and emphasis to their expropriation record. The major drawback of these approaches is that the U.S. leverage, our allocation, with the Bank is being reduced.

Bank President Clausen, however, is extremely interested in this area and has expressed the view that internatonal rules, some of which perhaps might reside in the Bank, should be developed. We might wish, therefore, to investigate with bank officials what our current thinking and plans, if any, are with regard to this issue.

Suggested Strategy

Before the OECD Ministerial we need to develop agreement on a fairly detailed statement of the investment issues we would like to address internationally. We also need to begin now to lobby other countries on investment issues and a proposal in the investment area. Some country contacts have already been made.

At the OECD Ministerial we need to build on our current program of work in the OECD to emphasize the importance of investment issues and hopefully escalate work on these areas.

We should attempt at the Economic Summit to get participants to:

-- reaffirm their commitment to strive for a free and open system for trade and investment;

-- reaffirm their commitment to existing principles that have been developed in the OECD and elsewhere;

-- recommend that work on international investment issues, in various fora, should be intensified and escalated in order to clarify issues, determine their impact and consider what actions

might be adopted to eliminate or discipline these measures;

-- recognize that the newly industrialized countries (NIC's) need to be brought into any global understanding on investment. These countries are important players in the world trading system, are beginning to export capital, and their national policies (for example on incentives) may be very harmful to other developing countries. Also any standards relating to investment should take into account the different stages of economic development of these countries; and

-- agree that a major objective of the GATT Ministerial should be to underscore the existence of these problems and to initiate a comprehensive work program on trade related investment measures (i.e., both incentives and disincentives, such as performance requirements).

Following the May OECD Ministerial and the June Summit, we should continue to work internally to refine our objectives and our proposal for the GATT Ministerial and to lobby key countries for their support of this exercise. At this stage we should discuss our proposals with private and Congressional representatives. We may also wish to consider at a later date legislative proposals to support our GATT initiative.

Ideally, work on specific issues in the various fora should be synchronized as much as possible and redundancy should be avoided. This would allow us to pull together work conducted in various fora in an efficient and timely manner with a minimum of conflicting results.

Chart 1

Division of Investment Issues (Entry/Treatment)

and Relevant International Institution

Issue	International Institution
Entry Issues	
Right of Establishment	OECD (CMIT--Capital Movements Code)
Screening Mechanisms	CMIT
Performance Requirements (export, local content), employment, et.al.)	OECD (CIME-CMIT-Trade Committee) GATT (Art.XXII-XXIII vs. Canada) IFC Study
Incentives	OECD (CIME) IFC Study
Other Requirements (technology transfer, equity participation, repatriation of earnings, location, financing, et.al.)	OECD (CIME) IFC Study UN Codes
Treatment Issues	
National Treatment	OECD (CIME--Declaration) UN Codes
MNC Guidelines	OECD (CIME) UN (Codes)
Nationalization and Compensation	OECD (CIME) (Convention) UN World Bank (expropriation policy)
Dispute Settlement	ICSID, ICJ

3/23/82

The Opportunities for International Economic Cooperation

All Summit countries share the same long-term goal of stable, vigorous, non-inflationary growth, reduced unemployment and greater stability of exchange rates. The task is to translate this agreement on objectives into effective policies. In addition to the direct benefits, success on this front is essential for effective cooperation on other policies to expand trade and development.

The domestic economic policies of each nation reflect the influence of its particular historical, cultural, and institutional situation. In addition, countries vary widely, in size and natural endowment, have diverse analytical concepts and theories, and operate with differing social structures. Thus, national sovereignty with respect to economic policy is, and will continue to be, a basic feature of the international economic system. But we must all recognize the consequences of our policy differences. The trade and financial linkages of an interdependent world severely limit the ability of any nation to insulate itself from the impact of the economic policies and performance of others and require that we recognize the limits on how far we can differ in domestic policy.

Many current economic problems are the result of basic divergences in our economic policies. We now have two choices: to correct the underlying divergencies, or to try to mask their symptoms by suppressing market signals. The United States prefers the former. We believe that where exchange markets are unstable due to differing economic policies and performance, exchange market intervention or capital controls cannot succeed in eliminating the basic divergences. Similarly, efforts to coordinate interest rates, in disregard of underlying market forces, would be futile.

It is clear, however, that not all policies and objectives are equally susceptible to international cooperation. There are limits to the scope for detailed coordination of policies. Recognition of these bounds is necessary to assure the full potential of cooperative efforts and to avoid actions which impede achievement of common long-term goals. We must distinguish between those areas where explicit <u>coordination of specific actions</u> is imperative, and those in which it is necessary to achieve <u>compatibility of overall policy approaches</u>.

The general policy issues which have international implications can be grouped into three categories:

(1) <u>Areas where the market mechanism would not be expected to yield the optimal result or where domestic policies have significant international</u>

externalities. In these areas sustained efforts by some countries clearly benefit others whose contribution is less than commensurate with their economic resources. While a nation which does not contribute to the joint effort would nevertheless benefit from the effort of others, the total benefit to the group is reduced. A deficient performance by some nations negates the efforts of the others or, at least, reduces their effectiveness.

These issues often extend into areas beyond that of direct economic policy, but have significant effects on economic performance. Included are policies contributing to mutual defense, and the expansion of trade and development through foreign aid. The common objective allows a clear determination of the roles of individual nations and allows for specific guidelines for the contribution of each country. Detailed cooperation is imperative in achieving mutual goals in these areas.

(2) Policies which interfere with the operation of competitive markets. These involve neo-mercantilist actions which attempt to transfer productive facilities from other countries or efforts to protect domestic activity from external competitive pressures. Included, among others, are certain export promotion schemes, tax and credit preferences for exporters; tax holidays for foreign investors; direct controls on prices, credit allocation and capital flows; and systematic intervention which distorts exchange markets.

The use of these policies, if unchecked, would result in enormous damage to the entire community of nations. Consequently, the case for explicit international coordination, in fact, harmonization, of efforts to eliminate anti-competitive policies is overwhelming.

(3) The broad range of domestic macroeconomic policies, which affect other nations through the economic interdependence of nations. This area presents the most difficult problem for international coordination but it is also a major source of current economic difficulties.

These policy differences among nations affect flows of goods, services, and capital and often are the primary source of instability in exchange markets. However, no precise short-run coordination, in the sense of synchronized timing or intensity of these policies is likely to be effective. Instead, establishing a universal commitment to discuss and relate basic domestic policies to long-term objectives is

necessary. While the timing and intensity with which these policies are implemented would vary across nations, the critical goal is the commitment of all Summit nations to view the consequences of their immediate actions over a longer-term perspective and to minimize fundamental divergencies among nations.

The secular policies of individual countries define the environment in which the international economic system operates. Establishing the prospect for sustained non-inflationary growth is a necessary condition for efficient and stable exchange markets.

The Benefits of Convergent Long Term Policies

There must inherently be a great rift between nations which are willing to tolerate domestic inflation as they pursue their internal social goals, and other nations which are committed to maintaining or achieving general price stability. Nations with inflationary policies have to recognize the exchange rate and balance of payments consequences of their policies. If they do not, they are led inevitably to institute capital controls, trade restrictions and exchange market intervention. Also, this fundamental policy imbalance leads to pressure on other nations to adopt accommodative domestic policies, misdirecting the spirit of international cooperation to short-run fine tuning of aggregate demand.

Efforts at international cooperation should focus on establishing the common resolve to reduce domestic inflation and to promote real economic growth through increased opportunities for productive investment. The challenge to this resolve continues to arise from the perceived conflict between each country's immediate domestic objectives and our mutual long-term interests. Short-term conditions are important and deserve attention, but that concern should be balanced by a view of the longer-term consequences of immediate policies. In fact, many current problems are only the immediate manifestation of long-term conditions which stimulate inflation, and discourage real economic growth. Thus, the ability of each of us to deal with short-term problems effectively is enhanced greatly by prior commitment of all of us to secular price stability and sustainable economic growth.

Secular policies to assure general price stability and to encourage real economic growth are the only method for achieving permanent expansion of job opportunities, low interest rates, and competitiveness in international markets. A policy of reallocating resources away from current consumption by both the government and the private sectors, and towards long-lived productive assets is, by definition, a policy for lowering real rates of interest and stimulating growth. The areas for increased attention and discussion are:

(1) Monetary discipline. While there are differing views on the sources of inflation, one of the few economic certainties is that

inflation can persist only where it is accommodated by excessive monetary expansion. Nations which experience inflation will have to reduce the trend rate of monetary expansion. Each nation must decide the speed of this adjustment, recognizing that international differences in the paths to lower inflation will be reflected in exchange and capital markets.

(2) Budget discipline. Increasing the sustainable pace of real economic growth requires that the burden of financing government spending must be shifted away from production, work and capital formation, toward consumption and leisure activity. This includes concerted effort to reduce the burgeoning credit demands of government which result from persistent budget deficits. Also, the incidence of taxation should be shifted away from production activity and the accumulation of capital.

(3) Internal flexibility. Differences within the private sector in the ability to adjust to economic shocks can create severe internal disruptions, which place strain on the discipline of the central government. Willingness of government to protect existing industries, firms, and jobs when they fall victim to competitive forces is the source of considerable internal rigidity. Protection in one country inevitably leads to pressure for retaliation by trading partners.

Problems of the Transition to Less Inflation and Faster Growth

Reversing the trend of stagflation is not a quick or painless process. The immediate burden is real, and is substantially increased when the effort to implement longer term policies is half-hearted. However, the alternative is a steady erosion of standards of living for most nations, increased international tensions, and a decrease in ability to resist external economic, political and military threats.

The greatest impediment to the establishment of long-term policies to reduce inflation and stimulate growth is the lingering presumption of a lasting trade-off between inflation and unemployment. However, the experience of many nations over the past decade shows the sacrifice of sound long-term policies for the purpose of supporting domestic employment has led only to both more inflation and unemployment. Inflation and real economic growth are ultimately incompatible.

High and varying inflation imposes costs on a society by reducing standards of living in the future. Thus, the immediate temporary costs that result from imposing monetary discipline should be weighed against the permanent losses of output and employment which are certain to result from a failure to act. In an open international system the prospect of these future losses will be reflected in a steady depreciation of the domestic currency and a loss of competitiveness to nations which demonstrate a stronger commitment to price stability.

Establishing the credibility of an anti-inflationary policy is crucial to reducing the transition costs. This requires a demonstrated

commitment to monetary discipline, avoiding the temptation to sacrifice monetary control, even temporarily, to the immediate pressures of concern about interest rates and exchange rates. A variety of factors affect interest and exchange rates in the short run, not the least of which is concern about the commitment of monetary authorities to long-term control of money growth. Frequent, systematic intervention in both domestic and international markets aggravates those fears. Countries which have established some degree of monetary discipline have been able to maintain real growth -- and their commitment to maintain control has given them an advantage in absorbing economic shocks.

During the transition it is unlikely that the long-term policies of various nations would be perfectly in phase. The credibility of policy would vary from country to country, as would the relative intensity of the policy actions. This situation would be expected to yield temporary imbalances in both domestic and international markets, as expectations adjusted at varying rates. These transitory disruptions can be reduced, but not avoided entirely.

The magnitude and duration of transitional problems is influenced greatly by public perception, both at home and abroad, of government's commitment to long-term policies. Expedient action, in the form of stimulus to demand and intervention in markets, is a clear signal of a lack of that commitment. Ironically, short-term efforts to suppress the transitional effects of adjustment to noninflationary pro-growth trends can be expected to worsen the immediate economic situation. The same holds for efforts by a government to avoid the immediate domestic consequences of the adoption by other nations of long-term policies which are more credible than its own.

In summary, international economic problems have been aggravated by a failure to achieve the common goal of non-inflationary economic growth. Divergent long-term policies are reflected in volatility of current exchange markets and needless fluctuations in economic activity. This situation requires more emphasis on long-term policy and less on synchronization of short-term aggregate demand programs within each nation. The potential benefits are enormous and are measured in terms of more jobs, lower and less variable interest rates, stable prices and elimination of the major force behind volatility of exchange rates.